First Trust
Monday Morning OUTLOOK
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Fed Forecasts Depend on Data

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The Federal Reserve is doing everything in its power to hold down long-term interest rates because it thinks that doing so will help lift economic growth. In addition to quantitative easing I & II, the Fed is buying long-term Treasury bonds and also promising to hold short-term interest rates low for an extended period.

Since long-term interest rates are just a series of short-term yields strung together, promising to hold short-term rates down can influence long-term interest rates. The Fed thinks that this will help lift housing and the economy and push down unemployment.

Last summer, the Fed promised to hold rates down through mid-2013. Headlines from last week suggest that the Fed now thinks 2014. But, how committed is the Fed to this strategy? What will it take to change course? Some analysts argue that this is an ironclad commitment and there will be no course changes.

We believe this is a misreading of the Fed's intentions. There are 19 potential economic views that are important at the Federal Reserve – 7 are on the Board of Governors and 12 are Presidents of regional banks. Right now, two Governorships are un-filled, which means there are 17 forecasters (12 Regional Bank Presidents and 5 Governors). Of these, six expect a rate hike before the end of 2013. Of the 11 who think rates will end 2013 where they are today, five expect a rate hike before the end of 2014. In other words there is more disagreement at the Fed than meets the eye.

In his press conference after the release of these forecasts, Fed Chairman Ben Bernanke said that if the economic data proves the Fed either too optimistic or too pessimistic, it would most likely change its forecast and alter policy expectations.

In other words, faster growth, lower unemployment, and higher inflation – like we anticipate – would move up the start of rate hikes before late 2014, possibly even before mid-2013.

Within the Fed's new and more transparent communication of its economic beliefs there are some very important pieces of data. While members forecast their near-term expectations for growth, inflation and interest rates, they also put figures on what they deem to be the long-term, steady-state, equilibrium world.

Every single one of the 17 forecasts put the long-run forecast of an appropriate (equilibrium) federal funds rate at or above 3.75%. This is not a surprise. Fed forecasters judge the equilibrium growth rate for long-run nominal GDP to be 4.3% to 4.6% - about 2% inflation and 2.3% to 2.6% real GDP.

We look at these two long-run forecasts as consistent with our models which use nominal GDP growth as a target rate for the federal funds rate. The only problem is that nominal GDP grew 3.7% in 2011 and 4.2% at an annual rate over the past two years. In other words, the current economy is already very close to the Fed's long-run forecast. This means that the federal funds rate is currently too low. A zero percent rate with growth already near 4% makes no sense from a monetary policy perspective. The funds rate should be much higher if the goal is keeping inflation stable.

But the Fed is convinced that it can keep rates below its long-run levels without risk of inflation because the economy has unused potential (high unemployment and unused capacity). The Fed thinks the housing market needs zero percent interest rates to heal and to grow again.

We think this is a mistake. For example, a zero percent interest rate may not even be low enough to boost housing, but the same zero percent rate is already too low for manufacturing or farming or commodities. In the 1970s, when the Fed unwisely attempted to bring unemployment back down to levels it thought were sustainable, the US experienced its worst inflation ever. We side with those members of the Fed who want rates up sooner rather than later. However, the Fed is a democratic organization and right now those hawkish members are outnumbered by the ones who think the economy can be manipulated.

As a result, look for growth and inflation to continue heading higher. This is a short-term positive for stocks and the economy, but it comes with a long-term downside. It's called inflation.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
1-30 / 7:30 am	Personal Income - Dec	+0.4%	**+0.3%**	+0.5%	+0.1%
7:30 am	Personal Spending - Dec	+0.1%	**+0.0%**	+0.0%	+0.1%
1-31 / 8:45 am	Chicago PMI - Jan	63.0	**64.6**		62.5
9:00 am	Consumer Confidence - Jan	68.0	**70.3**		64.5
2-1 / 9:00 am	ISM Index - Jan	54.5	**54.8**		53.9
9:00 am	Construction Spending - Dec	+0.5%	**+0.1%**		+1.2%
4:00 pm	Dom. Auto & Truck Sales - Jan	10.5 Mil	**10.5 Mil**		10.4 Mil
2-2 / 7:30 am	Q4 Non-Farm Productivity	+0.8%	**+0.7%**		+2.3%
7:30 am	Q4 Unit Labor Costs	+0.9%	**+0.2%**		-2.5%
7:30 am	Initial Claims - Jan 28	370K	**377K**		377K
2-3 / 7:30 am	Non-Farm Payrolls - Jan	150K	**142K**		200K
7:30 am	Private Payrolls - Jan	168K	**160K**		212K
7:30 am	Manufacturing Payrolls - Jan	11K	**8K**		23K
7:30 am	Unemployment Rate - Jan	8.5%	**8.5%**		8.5%
7:30 am	Average Hourly Earnings - Jan	+0.2%	**+0.2%**		+0.2%
7:30 am	Average Weekly Hours - Jan	34.4	**34.4**		34.4
9:00 am	Factory Orders - Dec	+1.5%	**+1.7%**		+1.8%
9:00 am	ISM Non-Man. - Jan	53.2	**53.6**		52.6